

The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress

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States play an important role in assisting municipalities in times of financial distress. Traditionally, states have attempted to supervise local government financing and limit volatility through the enactment of debt limitations and laws that permit the refunding of municipal obligations. Over time, states have developed more sophisticated mechanisms of assisting and providing oversight to their municipalities through the use of receivers, financial managers, and oversight and refinance authorities. Each state has its own, unique approach to these mechanisms. States, mindful of their past efforts, must now develop new mechanisms or fine-tune existing ones to deal with the increasing financial challenges of the future. This paper describes various protections and methods that have been adopted by states to ensure payment of debt obligations by local governments and to provide financial assistance, new mechanisms, and oversight.

Given our unique form of federalism in the United States, the federal government and states are co-sovereigns, and municipalities are the sub-sovereigns of our state governments. The

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state is intended to be the supervising adult, particularly with regard to the financial health of its municipalities and the ability to access the municipal finance market.¹ By assisting the fiscal health of its municipalities, the state will ensure that its local governmental bodies retain the independence and freedom to finance necessary improvements without the unnecessary interference of the federal government. The states value the system of municipal finance that has permitted a state and its municipalities to determine, on a local basis, what essential governmental services they desire and to finance such necessary improvements without the need of federal approval. This can continue only if the municipalities, through the assistance of the states, continue to be viewed in the financial markets as strong credits. The states have adopted various approaches to maintain the financial credibility of local governments and the valued access to the capital markets that is at the heart of our system of federalism.²

Various states have adopted different vehicles to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. At their most basic, these methods, which may be found in legislation or constitutional provisions, include limitations on debt and taxes and on the authority to refinance

¹ See *The Federalist Papers* by Alexander Hamilton and James Madison, Nos. 32 and 39. As defined in the U.S. Bankruptcy Code, the term “municipality” includes cities, counties, villages, towns, school districts, special tax districts, and municipal utilities and enterprises so long as they are instrumentalities or agencies or subdivisions of the state. Typically, the state has a special interest in the financial well-being of its cities, counties, villages, and towns.

² This paper, taken in part from the author’s book *Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies* (Chapman and Cutler LLP, 2012), is dedicated to the wisdom, scholarship, and leadership of the late John Petersen. John was an analytical and moral compass for state and local government and financial analysis, and this paper recognizes his influential work and effort, including his paper “State Role in Local Government Financial Management,” Government Finance Research Center, Washington, DC, June 1979. I was privileged to know John for most of my professional career and to learn from him and his insight on government finance in good times and in bad. I was honored to work with John in trying to encourage the Washington Public Power Supply System’s (WPPSS) participants to honor their obligations and resolve their dispute in an effort to prevent the then-largest municipal default. I was also fortunate to work with John in discussing with sub-sovereigns outside the United States the structure of government that allows local governments to determine locally their desired improvements and services and to fund them locally in the capital markets. Most of all, I was blessed with John’s friendship and the opportunity to discuss current issues in government finance in order to better service state and local governments. As fellow members of the Society of Municipal Analysts, I and other members had the pleasure of meeting regularly with John and his wife and discussing matters of current interest. We all have become better for having John walk with us for as long as he did.

outstanding debt. More hands-on involvement by the states arises in the event of financial distress. Procedures devised for such situations generally start with the requirement to balance the budget and progress to review, assistance, and oversight by the states of municipal budgets and financial issues.

In addition, states have developed unique approaches to the oversight, supervision, and assistance of local governments in times of emergency. These include advisory commissions that review the financials, the budgeting and financing done by municipalities, receiverships, financial managers, financial control boards, refinance authorities, oversight commissions, and others. Although these mechanisms vary by type and degree of supervision and assistance, the development of these mechanisms indicates the growing trend of more active oversight and supervision of municipalities in order to better address the economic distress that local governments face and thereby to build better credibility with citizens and creditors, including the municipal bond market.

THE PURPOSE OF STATE AND LOCAL GOVERNMENT

The purpose of state and local government has been, and always will continue to be, providing essential governmental services to citizens at a level that they deem is acceptable and desired. Access to the credit markets at reasonable rates of interest is an important objective of government finance officers. Our form of representative government has provided the extensive and sophisticated public works system the United States has enjoyed on a state and local level, including more than 4,000,000 miles of roadway; over 600,000 bridges; more than 1,100 local bus systems; almost 20,000 airports, of which more than 5,000 are in public use; more than 25,000 miles of inland coastal waterways and almost 84,000 dams; more than 2,000,000 miles of pipes and water supply systems; and more than 15,000 wastewater treatment plants.³ This infrastructure has created, for our states and federal government, the basis for our national welfare and economic growth.

³ National Transportation Statistics, Table 1-1, available at http://www.bts.gov/publications/national_transportation_statistics/pdf/entire.pdf; National Inventory of Dams, available at [http://geo.usace.army.mil/pgis/f?p=397:5:1081121975602189::no\(dams\)](http://geo.usace.army.mil/pgis/f?p=397:5:1081121975602189::no(dams)); 2006 Community Water System Survey Report, available at <http://water.epa.gov/aboutow/ogwdw/upload/cwssreportvolume12006.pdf>.

FINANCIAL CYCLES REQUIRE THAT STATE AND LOCAL GOVERNMENTS PREPARE FOR ECONOMIC DOWNTURNS

The impact of economic cycles has been demonstrated throughout the history of state and local government debt financing.⁴ Unfortunately, we all recognize an adverse effect of downturns, namely, lower state and local government revenues. Nevertheless, economic downturns provide no holiday from the threat of higher state and local government expenses, which are highlighted by the ever-increasing need for improvement in infrastructure, education, health care, and public safety. Past downturns during the 1800s, such as the Panics of 1819, 1837, and 1857 and the repudiation of debt by the 13 states after the Civil War, have had consequences. These crises led to the demand for more than moral commitment on the part of issuers of public debt. They led the market to demand, and state and local governments to offer, statutory and constitutional provisions to provide protections to bondholders if the state and local governments experience financial difficulties and fail to pay their debt obligations in a timely manner or default. Over time, various new mechanisms have been introduced to provide supervision and assistance to those local governments that are experiencing financial distress. Now is the time to reassess and consider whether lessons learned should motivate the states to consider modifications or changes geared to address the perceived future needs and problems facing local governments and their financial creditors.

There is no reason any local government should have to endure, without supervision or assistance, the devastating effects of a financial meltdown and possibly to resort to the filing of municipal bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. The role of state government should be to help detect and address financial problems before the financial collapse of a municipality is irreversible. Traditionally, states have worked with their local governments to avoid financial meltdowns and bankruptcy, and there is no reason to believe that tradition will not continue.

⁴ Since 1949, there have been 11 economic downturns in the United States, and the states and their local governments not only have weathered those financial storms but have provided substantial support to the eventual economic recovery by expenditures for infrastructure and other purposes that have increased employment and GDP growth. In each of these economic downturns, increased government debt financing for needed essential infrastructure and improvements was what helped provide the stimulus for recovery. These bond-funded projects have stimulated the economy by providing increased employment for construction, purchase of goods, and the ripple effect that such increases in salaries and purchases have on tax revenues, employment, and GDP. See Appendix A to Chart on Economic Downturn and Recoveries compared to state and local government spending in *Municipalities in Distress*.

THE GOAL OF THIS PAPER

It is the purpose of this paper to describe the various protections and methods that have been adopted by states to ensure payment of debt obligations by local governments and to provide financial assistance and oversight. Further, the paper will highlight the existing methods by which states can provide assistance to municipalities and whether or not states should expand and enhance the mechanisms available to address financial distress in their municipalities based upon the proud history of municipalities paying their debts in full and generally on time.⁵

In times of severe economic difficulties, much uncertainty exists in the municipal markets. This certainly relates to whether municipalities will be able to pay the principal and interest owed on the long-term debt and also the lack of clarity as to when and whether state assistance and aid will be available should it become clear that a municipal default may occur. Further, investors express great concern that a municipality ultimately will file a municipal bankruptcy petition under Chapter 9 without any attempt to work with investors in a restructuring.

In reality, states have enacted a plethora of laws to help rehabilitate municipalities before they reach such an untenable position. The last resort has been, and should hopefully continue to be, access to and use of Chapter 9 as a means of adjusting municipal debt. Rarely have municipalities filed Chapter 9, and states generally have been reluctant to provide carte blanche access to Chapter 9 because of the effect Chapter 9 authorization may have on future market access and cost of borrowing for its various municipalities as well as the state itself.

CAUSES OF FINANCIAL DISTRESS

Although the debt of state and local governments continues to be viewed by the market as among the more secure investments, a number of factors have heightened the need for continued state and local governments' cooperation to anticipate and deal with municipal distress. These factors include:

1. Unaffordable and unsustainable personnel costs, especially pensions;
2. Deferred costs of capital improvements and infrastructure costs;
3. Recent and unaddressed natural or manmade disasters;

⁵ This paper has the benefit of the excellent thought and guidance of John Petersen, including not only his work on the "State Role in Local Government Financial Management" but also his recent book *The Oxford Handbook of Government Finance* (2012) and his article "Municipal Defaults: Eighty Years Make a Big Difference," which appears in this journal.

4. The bursting of the U.S. state and local government debt bubble;
5. Decline of urban areas;
6. Flight from the Rustbelt to the Sunbelt;
7. Proposition 13 mentality: the popularity of tax caps and limitations;
8. Lingering legal issues and surprise court decisions;
9. Off-balance sheet liabilities; and
10. Willingness to pay vs. ability to pay: willingness to pay traditionally has not been a problem but could be a growing problem.

Although historically there has been a low default rate for bonds issued by municipalities and states,⁶ it is of great importance for the basic credibility of state and local governmental financing that defaults be kept to a minimum. The following pages discuss how states have attempted to supervise state and local government financing as well as new approaches that may be used to preserve the strong debt repayment record municipal finance has enjoyed.

HOW STATES HAVE ATTEMPTED TO SUPERVISE STATE AND LOCAL GOVERNMENT FINANCING AND VOLATILITY IN TIMES OF ECONOMIC DISTRESS

Historically, states have adopted various mechanisms to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. In the past, these mechanisms primarily have started with basic limitations on debt and taxes and authorization to issue refunding bonds.

At the front lines of protecting the financial status of local government are constitutional and statutory limitations on the debt municipalities may have outstanding at any time. In addition to debt limitations, all states include provisions in their statutory law for the issuance of refunding bonds.

Debt Limitations

One of the most important protections for municipalities and their creditors is the limitation that the various states have imposed on the amount of

⁶ As John Petersen noted in his paper “Municipal Defaults: Eighty Years Make a Big Difference,” between the 1970s and 2000s, the municipal default rate for municipalities averaged 0.10% to 0.24% per decade (adjusted for WPPSS and Jefferson County, Alabama), not including the fact that more than 80% of the defaults were conduit financings and not essential public financings. This is a far cry from corporate bond cumulative global default rates from 1970 to 2007 for investment grade and non-investment grade of over 10%. “Moody’s Global Corporate Finance Default and Recovery Rates, 1970–2007” (February 2008).

debt a municipality may issue and hold at any one time—in fact, all states with the exceptions of Alaska, Florida, and Tennessee impose some sort of limit.⁷ Municipalities in 28 states are restricted by limits imposed by their respective constitutions; 21 states that impose debt limitations on their municipalities do so via statutory provisions.

These municipal debt limits range from a percentage of a valuation of assessed property in the local unit of government to a set monetary amount.⁸ In addition, states handle debt for certain “essential” services differently. For instance, in Arizona, while the constitutional debt limit with voter consent is 15% of the taxable property in the local unit of government, if bonds are issued for supplying a town or city with water, artificial light, or sewers or for purchasing and developing land for open space preserves, parks, playgrounds and recreational facilities, public safety, law enforcement, fire and emergency services facilities, or streets and transportation facilities, the debt limit increases to 20%.⁹ In Kansas, bonds issued by cities for sewer systems or to acquire or enlarge a municipal utility, and certain street improvement bonds, are not counted toward the issuing city’s bond indebtedness calculation.¹⁰ Revenue bonds issued in Kansas are also not included in this calculation.¹¹ In Arkansas, industrial development bonds do not count toward the state’s debt limit.¹²

In Idaho, two-thirds of voters must approve bond issuances in which a local government would incur debt exceeding the income and revenue the local government would receive in a year. Should voters approve a bond issuance, the state constitution requires that the local government collect an annual tax sufficient to pay the bond interest as it comes due and to establish a sinking fund for payment of the principal within 30 years.¹³ A few states, such as Louisiana, have set debt limits based on the type of project.¹⁴ The Puerto Rican constitution directs its legislature to

⁷ Even Alaska and Florida have some indirect control on debt. Alaska has a limitation on taxes and a municipality may not levy ad valorem taxes for any purpose in excess of 3% assessed value of the property in the municipality. However, these limitations do not apply to taxes levied for payment of principal and interest on bonds. Alaska Stat. §§ 29.45.090, 29.45.100 and 29.47.200 (2012). Florida has a limitation on ad valorem taxes to finance or refund capital projects only if approved by the voters.

⁸ Compare Alabama—Ala. Const. Art. XII, § 225 and Ark. Const. § 342 (2012) (debt may not exceed a particular percentage of valuation) with Washington, DC—D.C. Code § 47-102 (setting debt limit at 1878 levels). Alabama is somewhat unique in providing that any tax to be levied must be levied by the state legislature and does not grant the local government the power to levy taxes on its own.

⁹ Ariz. Const. art. IX, § 8.

¹⁰ Kan. Stat. § 10-309.

¹¹ *Ibid.* at § 10-311.

¹² Ark. Const. § 62 (2012).

¹³ Idaho Const. art. VIII, § 3.

¹⁴ La. Const. art. VI, § 34; La. Rev. Stat. § 39:562.

fix municipal debt limits, but the limits may not be less than 5% or more than 10% of the aggregate tax valuation of the property within the municipality.¹⁵ In other states, such as Rhode Island, a debt limit has been set for cities and towns, but the debt measurement is net of any tax anticipation bonds and the amount in any sinking fund.¹⁶

There have been recent attempts in some states to tighten local debt limits. For instance, in November 2010, Colorado voters considered a state constitutional amendment that would have greatly limited the ability of local governments to borrow funds. This amendment, which was overwhelmingly defeated by 73% of voters, would have prohibited local government borrowing after 2010, unless the voters approved the borrowing. Specifically, the amendment would have required voter approval for all borrowing, limited local government borrowing to bonded debt, and established a debt limit for local governments of 10% of the assessed value of the real property therein. The length of borrowing would also have been reduced from the typical term of 20 to 30 years to a constitutional limit of 10 years. Currently, Colorado imposes a debt limit on the bond indebtedness of school districts to the greater of 20% of the last valuation on taxable property or 6% of the most recent determination of actual value of the property.¹⁷ Rhode Island has recently (July 2011) enacted legislation that payment of bond debt will have a first priority lien on revenues of a municipality in order to assure the municipal market of the dedication to payment.¹⁸

Although states attempt to limit the amount of debt that their municipalities may incur, local governments sometimes take certain actions to avoid these debt limitations. For instance, revenue bonds financed by particular rents, tolls, or charges generated from a project are exempt from debt limitation calculations in many states. Similarly, many local governments issue tax increment financing (TIF), which generally is not counted in the debt limitation valuation. In fact, the Supreme Court of Iowa has held that a TIF district's issuance of bonds does not count toward a city's constitutional debt limit because the bonds are not a legally enforceable obligation of the city.¹⁹ In other situations, a local government may attempt to use "nonappropriation" financing, in which a local government agrees to make rental payments on a facility built by either a private company or a public entity. The payment of the rent

¹⁵ P.R. Const. art. VI, § 2.

¹⁶ R.I. Gen. Laws § 45-12-2.

¹⁷ Colo. Rev. Stat. § 22-42-104.

¹⁸ 2011 R.I. Pub. Laws 277 (signed into law July 12, 2011). This provision has been tested successfully in the bankruptcy proceeding involving the City of Central Falls, Rhode Island.

¹⁹ *Fults v. City of Coralville*, 666 N.W.2d 548 (Iowa 2003).

is contingent on the local governing board's annually appropriating money for the rental payment. The courts have had a mixed reaction as to whether so-called "nonappropriation" funding should be counted in a local government's debt limit.²⁰ In California, there are three major exceptions to the state constitution's debt limit, including the "Offner-Dean" lease exception allowing for certain long-term lease obligations, if meeting certain criteria, to be exempt from the state's debt limit; the "Special Fund Doctrine," which is a judicially created debt limit exception applicable to long-term indebtedness financed through a special fund, such as enterprise revenues; and the "Obligation Imposed by Law" exception applicable to involuntary indebtedness such as a money judgment.²¹ Also in California, municipalities sometimes issue "certificates of participation," a strategy generally exempt from state constitutional debt limits, where local governments market lease obligations through the retail securities market by means of certificates of participation that pay tax-exempt interest and are liquid.²² These are just a few examples of strategies that a municipality might use to circumvent a constitutionally or statutorily imposed debt limit. The details of these limitations vary by state, so the specific laws and process of a particular state should be consulted before over-generalizing. As we reflect on past economic downturns and the struggles of local governments, there should be consideration of fine tuning or adjusting debt limits and tax limits to enhance and assure financial strength.

Refunding Bonds

The most common way that municipalities restructure their debt is through the issuance of refunding bonds. Refunding bonds, as the name implies, are bonds that are issued to redeem the principal of outstanding bonds. Every state provides some sort of refunding bond provision for its municipalities. By issuing refunding bonds, a municipality may be able to refinance its debt at a more favorable interest rate or restructure its outstanding obligations to mature at a time when the municipality

²⁰ Compare *Shulz v. State*, 639 N.E.2d 1140 (N.Y. 1994) (upholding "nonappropriation" financing as exempt from debt limit) with *Brown v. City of Stuttgart*, 847 S.W.2d 710 (Ark. 1993) (rejecting notion that "nonappropriation" financing is exempt from debt limit).

²¹ For a more detailed discussion of California debt limitations and the issuance of public bonds in California in general, see California Debt and Investment Advisory Commission, *California Debt Issuance Primer* (2005), available at <http://www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf>.

²² For a general overview of lease financing and certificates of participation in California, see California Debt and Investment Advisory Commission, *Guidelines for Leases and Certificates of Participation* (1993), available at <http://www.treasurer.ca.gov/cdiac/reports/Guidelines93-8.pdf>.

believes it will be more flush with money. Refunding bonds also may help a municipality to push off its debt troubles for another day. In most cases, the issuance of refunding bonds does not result in an increase in outstanding debt, because the refunded bonds no longer count toward the legal limits.

Refunding bonds generally may be issued at any time before the final maturity of the debt to be refinanced. Although municipalities generally have flexibilities in refunding their current obligations, many states impose provisions limiting the use of refunding bonds in an attempt to protect the financial solvency of a particular municipality. For instance, in Pennsylvania, refunding bonds may be issued only to:

1. Reduce total debt service over the life of the bond issuance;
2. Reduce annual debt service;
3. Eliminate unduly burdensome or restrictive covenants or restrictions;
4. Refund any maturity or maturities to a later date;
5. Substitute bonds for notes or bond anticipation notes or to substitute notes for bonds; or
6. Adjust lease rentals.²³

Pennsylvania law further limits municipalities in their issuance of refunding bonds by disallowing local governments from extending the term of the outstanding debt through refunding to a maturity date that could not have been included in the original issue, unless “in the case of an emergency refunding of stated maturity date to avoid a default occasioned by an unforeseen shortage in total revenues.”²⁴ This provision, however, would apply only if the municipality in question were to first petition the state government and the petition were to receive state approval.²⁵ Other states have similar provisions with respect to circumstances under which a municipality may issue refunding bonds.

Conclusion

By setting debt limits and taxing limits and allowing for the issuance of refunding bonds, the states have attempted to curb the number of municipal financial crises and defaults. In addition to these provisions, and as discussed in the next section, some states have gone a step further to help beleaguered municipalities resolve their financial issues at the initial signs of a problem.

²³ 53 Pa. Stats. §§ 8241-8251.

²⁴ *Ibid.* at § 8243.

²⁵ *Ibid.*

THE USE OF VARIOUS MECHANISMS BY STATES TO PROVIDE FINANCIAL OVERSIGHT AND ASSISTANCE TO MUNICIPALITIES IN DISTRESS

The limitation on indebtedness and authorization to issue refunding bonds are the basic tools in the states' arsenal to assist municipalities. However, in times of financial distress, these basic approaches have been enhanced by additional mechanisms. These methods have started with reaffirming statutory requirements to balance budgets and progressed to greater state assistance and oversight of municipal budgets and finances in times of financial emergency as well as the use of receivers and financial managers and oversight authorities. States have approached the task of supervising and assisting their municipalities in a variety of ways. Although these mechanisms vary by type and degree of supervision and assistance, the widespread development of these mechanisms indicates the growing trend of more active oversight and supervision of municipalities by states in order to build better credibility with citizens and creditors, including the municipal bond market.

Introduction

Twenty-three states have implemented municipal debt supervision or restructuring mechanisms to aid municipalities. These programs, many of which are identified in Table 1, below, range from the California Debt and Investment Advisory Commission and the Florida Local Government Financial Technical Assistance Program, which provide guidance for and keep records of the issuance of municipal bonds in those states, to the layered approach of Rhode Island to aid municipalities depending on a municipality's level of financial instability. States with these provisions have effectively used these mechanisms to control the restructuring of their municipalities. For instance, as will be discussed, the State of Michigan, under its process for dealing with distressed municipalities, has traditionally denied a request by its municipalities to file a petition under Chapter 9, likely concluding that its state's restructuring mechanism was more effective in handling the municipality's crisis. Since 1954, only two Michigan municipalities have filed for Chapter 9 protection, the Village of Merrill and Addison Hospital. Since 2012, Detroit has been operating pursuant to a Consensual Agreement and has recently undergone further financial review, as ordered by the governor, and the appointment of an emergency manager. States that contain provisions allowing for state intervention into a municipality's finances are listed in Table 1.²⁶

²⁶ *Municipalities in Distress?* at pp. 25–26 and chap 7.

Table 1: State-Implemented Programs to Aid Municipalities	
State	Intervention Provision
Arizona	School District Receivership
California	Debt and Investment Advisory Commission
Connecticut	Ad Hoc State Intervention
District of Columbia	Financial Responsibility and Management Assistance Authority
Florida	Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program
Idaho	Debt Readjustment Plans
Illinois	Financially Distressed City Law and Financial Planning and Supervision
Indiana	Distressed Political Subdivision Protections and Township Assistance and Emergency Manager
Kentucky	County Restructuring Provisions
Maine	Board of Emergency Municipal Finance
Massachusetts	Ad Hoc State Intervention
Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act and Local Financial Stability and Choice Act
Minnesota	Back-Up Payment Procedures for Municipalities and School Districts
Nevada	Local Government Financial Assistance and Audit Enforcement Act
New Hampshire	Emergency Financial Assistance
New Jersey	Local Government Supervision Act and Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act
New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board
North Carolina	Local Government Finance Act
Ohio	Fiscal Watch; Fiscal Emergency; and the Fiscal Emergencies and Financial Planning and Supervision Commission
Oregon	County Public Safety Emergency and Fiscal Control Board and Municipal Debt Advisory Commission
Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act
Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission
Texas	Municipal Receivership
Wisconsin	Deficiency Protection for Public Improvement Bonds

States Recognizing Municipal Receivers: Rhode Island and Texas

In Rhode Island, the City of Central Falls petitioned a state court and was placed into judicial receivership for its financial woes in May 2010. The city of 18,000 had more than \$20 million of general obligation

debt.²⁷ In response to the city's filing for judicial receivership, in June 2010, Rhode Island enacted a law providing a process of progressive state intervention for municipalities in financial distress. The new law created a three-step process for distressed government, in what was possibly an attempt by Rhode Island to prevent ad hoc efforts by municipalities to restructure with tactics that could be unfriendly to the municipal markets.²⁸ The law applied retroactively to prevent the Central Falls judicial receivership from continuing.

After the legislation became law, Central Falls was placed into municipal receivership when a state commission found that the municipality had insufficient power to restore fiscal responsibility. The City Council of Central Falls attempted to challenge the new state law, but a state court judge in October 2010 upheld the constitutionality of the state-appointed receiver. Shortly thereafter, in November 2010, the receiver exercised his significant power to disband the Central Falls City Council and replace it with a three-member Advisory Council. The receiver publicly stated that he fired the council because "several members of the City Council have chosen to continually obstruct our efforts to return fiscal stability to the City."²⁹ In July 2011, the governor of Rhode Island signed into law legislation to give the municipal debt holders a guaranty of first rights to property taxes and general revenues of a municipality in the event of bankruptcy. This was in an apparent effort to demonstrate the creditworthiness and improve the market acceptance of Rhode Island's municipal debt.³⁰ On August 1, 2011, Central Falls' state-appointed receiver filed a Chapter 9 petition for municipal bankruptcy on behalf of the city. General obligation bondholders continued to receive payment on their bonds even after the filing because of the new Rhode Island law. This process has the effect of removing municipal bond debt from the Chapter 9 debt adjustment process and the use of the receivership to prepackage the structure and focus of a plan of debt adjustment on non-bond debt so as to lead to a more effectual and expedited Chapter 9 process.

In addition to the recent Rhode Island law and a law in Texas allowing for a judicially appointed municipal receiver, other states have chosen to allow for a financial control board, emergency managers, coordinators, overseers, or a financial commission to aid troubled municipalities. The concept of a

²⁷ Patrick McGee and Taylor Riggs, "Central Falls Aims to Protect GOs" *Bond Buyer*, August 1, 2011; Available at <http://www.bondbuyer.com/news/central-falls-bankruptcy-1029523-1.html>.

²⁸ See "Assembly and Governor OK Measure to Prevent Municipal Receivership"; Available at <http://www.rilin.state.ri.us/news/pr1.asp?prid=6591>.

²⁹ Romy Varghese, "Receiver Replaces Elected Council of Rhode Island City," *Wall Street Journal*; Available at <http://online.wsj.com/article/BT-CO-20101111-715808.html>.

³⁰ 2011 R.I. Pub. Laws 277 (signed into law July 12, 2011).

financial control board first made its appearance with the creation of a financial commission to oversee Manchester, New Hampshire, in 1921.³¹ Although the Manchester financial commission was appointed by the governor, the mayor and alderman of Manchester fixed the commission's compensation. The commission was allowed to control and regulate appropriations, expenditures, and bond issuances but could not control the collection of taxes.

Financial Control Boards and Their Progeny

Today, the laws of Florida, Illinois, Indiana, Michigan, Nevada, New Jersey, New York, North Carolina, Pennsylvania, and Rhode Island include a variation on a provision allowing for the appointment of a financial control board or commission, emergency managers, receivers, coordinators, or overseers over a troubled unit of local government. The intent of many of these provisions is to identify early signs of financial distress for a city or municipality so that the state may intervene before the city or municipality reaches the level of a municipal crisis. Importantly, such provisions are not just a web of buried state laws never to be used but, rather, are applied where situations call for intervention.

The New York Experience. Perhaps the most well-known appointment of a financial commission was the implementation of the New York City Financial Control Board in 1975. In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that, for more than 10 years, New York City had been using questionable accounting and borrowing practices to eliminate its annual budget deficits.³² Banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could be resolved only by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York City nearly defaulted on the payment of its notes in October 1975, and it was predicted that a default was likely in December absent federal aid.³³ In response, the State Municipal Assistance Corporation issued a series of securities on behalf of the city and a financial control board was appointed.

³¹ A.M. Hillhouse, *Municipal Bonds: A Century of Experience* (New York: Prentice Hall, 1936), p. 326; "Note, Missed Opportunity: Urban Fiscal Crises and Financial Control Boards," *Harvard Law Review*, 110 (January 1997), 733, 746–747.

³² For a detailed study of the New York City fiscal crisis see Donna Shalala and Carol Bellamy, "A State Saves a City: The New York Case," *Duke Law Journal*, 1976(6) (January 1977); United States Congress, House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (95th Cong. 1st Sess., August 1977).

³³ *New York Times*, October 19, 1975, Section 4 at 1.

The New York City Financial Control Board was given the power and responsibility to review and provide oversight with respect to the financial management of New York City's government. Among other things, the act establishing the board required the city to prepare and submit a "rolling" four-year financial plan to the Financial Control Board prior to the beginning of each city fiscal year. Although essentially dormant since the mid-1980s, the Financial Control Board can be reactivated if certain conditions are triggered, including the inability of the city to meet its debt service payments.³⁴

In addition to the New York City Financial Control Board, the New York Legislature may implement Emergency Financial Control Boards for any municipality outside of New York City. For instance, this provision was used in November 1975 to take control of the City of Yonkers (the board was terminated on December 31, 1978) and in January 2011 with regard to Nassau County.³⁵

The Pennsylvania Experience. Similar to the New York experience, Pennsylvania has implemented a series of provisions to aid ailing cities. Pennsylvania law contains the Financially Distressed Municipalities Act, which applies to any county, borough, incorporated town, township, or home-rule municipality.³⁶ Under these provisions, if the state's Department of Community Affairs determines that a municipality is financially distressed based on certain triggering events, the department may appoint a coordinator to guide the municipality in getting its financial affairs in order. There have been 28 filings under these provisions since 1987 and six rescissions of such filings. Examples of municipalities that were determined to be financially distressed include Pittsburgh in 2003, the Borough of Wilkensburg in 1988, and, most recently, Harrisburg in October 2010 and the City of Altoona in May 2012.

In addition to the Financially Distressed Municipalities Act, Pennsylvania law contains the Intergovernmental Cooperation Authority Act, which was created in 1991 to deal with insolvency issues faced by Philadelphia. The act created a five-member authority with authorization to enter into intergovernmental cooperation agreements with cities, and these agreements were preconditions to the issuance of any obligations by the authority. Among other things, the authority could issue bonds and the city and the authority were required to work together to develop a five-year recovery financial plan.

The Michigan Experience. Likewise, the State of Michigan, under its former Local Government Fiscal Responsibility Act, has taken over the Detroit Public Schools, the City of Pontiac, the City of Escorse, the Village

³⁴ See *Bond Buyer*, November 30, 1990, pp. 1, 45.

³⁵ David M. Halbfinger, "New York State Seizes Finances of Nassau County," *New York Times*, January 26, 2011, at A1.

³⁶ 53 Pa. Stat. §§ 11701.101-11701.501.

of Three Oaks, the City of Hamtramck, the City of Highland Park, and the City of Flint.³⁷ These provisions have recently been replaced by the Local Government and School District Fiscal Accountability Act.³⁸ Under this act, if a school district or municipality is in a perilous financial situation, the governor of Michigan may declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager be appointed, the emergency manager has broad powers to operate and restructure the municipality, including the ability to reject, modify, or renegotiate contractual obligations.³⁹ As a last resort, this emergency manager may file a Chapter 9 municipal bankruptcy petition on behalf of the municipality.⁴⁰ This Public Act 4 of 2011 provided for a Michigan emergency manager with extraordinary power. The act was very controversial, especially to local government bodies and elected officials. A referendum placed on the November 6, 2012, ballot defeated Public Act 4 of 2011, the Michigan Emergency Manager Law. On December 27, 2012, the governor of Michigan signed into law the Local Financial Stability and Choice Act,⁴¹ which replaced the defeated Public Act 4. Also in

³⁷ Former Mich. Comp. Laws. § 141.2802 (this provision has been replaced by the Local Government and School District Fiscal Accountability Act). See also Eric Scorsone, *Local Government Financial Emergencies and Municipal Bankruptcy*, Michigan Senate Fiscal Agency Issue Paper; Available at <http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf>.

³⁸ Mich. Comp. Laws §§ 141.1501-141.1531 (2011).

³⁹ Mich. Comp. Laws. § 141.1519 (2011).

⁴⁰ Mich. Comp. Laws. § 141.1523 (2011).

⁴¹ The new act contains 19 different possibilities that would allow for the state financial authority to conduct a preliminary review of a local government's finances to determine the existence of probable stress. The state financing board is required to complete a final report and then to submit that report to the local emergency financial assistance loan board to determine if probable financial stress exists for the local government.

If probable stress is found, the governor is then required to appoint a review team for that local government, and that review team, after investigating the circumstances and meeting with the local government, must submit a written report to the governor within 60 days following its appointment, although it may be granted one extension of 30 days to conduct its analysis. In its report, the review team must conclude either that a financial emergency exists or that one does not exist, and within 10 days of receiving the report, the governor must also make a determination as to the existence or not of a financial emergency. The decision is appealable to the Michigan Court of Claims within 10 business days by a resolution approved by two-thirds of the members of the local government's governing body.

Should a financial emergency be found, the local government must either (1) enter into a consent decree with the state, (2) agree to the appointment of an emergency manager, (3) enter into a neutral evaluation process, or (4) file a Chapter 9 bankruptcy petition if so approved by the governor. If it does not choose an option, the local government must proceed under a neutral evaluation process. Each of the options provides a process for resolving the causes of financial distress.

If the neutral evaluation process or other options do not result in a resolution, the governing body of the local government must adopt a resolution recommending that it proceed under Chapter 9 and submit that resolution to the governor and state treasurer for consideration and approval by the governor.

2012, Indiana passed legislation allowing its Distressed Political Subdivisions Appeal Board to appoint an emergency manager for its distressed subdivisions on grounds and with powers similar to the Michigan emergency manager.⁴²

Showing the seriousness with which Michigan and states with similar provisions take the filing by their municipalities of a municipal bankruptcy petition, in November 2010, the Emergency Financial Assistance Loan Board for the City of Hamtramck rejected a request by Hamtramck to file a municipal bankruptcy petition. This request was denied by the state that same month. The issue raised by the appointment of the emergency manager as an alternative to a Chapter 9 filing is: Does the emergency manager process vest too much power in one person who holds executive power and is not and cannot exercise judiciary or legislative power? Unlike court-appointed receivers or even court procedures, there is no guaranty of due process as certain rights are determined or abrogated. Further, the local government is supplanted by the emergency manager. This is a substantial difference from the financial control boards in New York, Act 47 in Pennsylvania, or oversight or financial review authorities in other states. Further, there are more inclusive and effective mechanisms that can be considered to enhance the ability to provide financial assistance and oversight while including local participation. The new Local Financial Stability and Choice Act, enacted in Michigan in December 2012, is one example of such a mechanism.⁴³

The Massachusetts Ad Hoc Experience. Similar to the laws of states establishing specific authority for financial control boards or similar commissions, Massachusetts has typically employed a system of implementing legislation on an ad hoc basis to create a financial control board or overseers for municipalities in severe financial distress. For instance, in the 1990s, the City of Chelsea was placed into a state receivership. The receiver cut city payroll by 25% and cut non-pecuniary employment benefits. In one year, the receiver was able to cut city expenses by \$5 million (10% of the city's budget).⁴⁴ In March 2010, the governor of Massachusetts signed into law provisions allowing the City of Lawrence to borrow \$35 million from the market and establishing a fiscal overseer for the municipality.⁴⁵ In a July 2010 report, the financial overseer reported that Lawrence's fiscal emergency was the result of years of mismanagement

⁴² Ind. Code § 6.1.1-20.3 *et seq.* (2012).

⁴³ Local Financial Stability and Choice Act, Mich. Pub. Act. 436 of 2012; Mich. Comp. Laws, § 141.1541 *et seq.*

⁴⁴ See Omer Kimhi, "Reviving Cities: The Legal Remedies to Municipal Insolvency," JSD thesis, New York University School of Law (2007), pp. 131, 205.

⁴⁵ See Chapter 58 of Acts of 2010.

and fiscal challenges. The fiscal overseer has aided the city in producing a balanced budget.⁴⁶ In another instance, in 2004 Massachusetts made a \$52 million state loan to the City of Springfield and established a financial control board to oversee the city.⁴⁷

The California Experience: Neutral Evaluator. California also has experimented with the concept of introducing a third party to assist in the resolution of municipal financial difficulties. California recently enacted a provision restricting the ability of its municipalities to file petitions to institute Chapter 9 proceedings.⁴⁸ The thrust of the legislation is to provide a period of objective and dedicated negotiation and resolution of issues affecting major creditors or financial problems. The legislation provides for a neutral evaluation process, otherwise known as mediation, for major creditors and parties to the financial problems. The neutral evaluator process provides a professional, independent, neutral advisor to serve as the supervising adult, which is the essence of a neutral evaluator. The neutral evaluator can foster negotiations among the municipality and representatives of major creditor constituencies, including workers and union representatives, vendors, contract suppliers, holders of major claims including bondholders, judgment creditors, or others whose interests could affect the financial fate of the municipality. The neutral evaluator process may not last more than 60 days from the date the evaluator is chosen unless the municipality or a majority of participating interested parties elect to extend the process up to an additional 30 days. The neutral evaluator procedure is intended to be an expedited process and cannot last more than 90 days from the date of the selection of the neutral evaluator.

The selection process of the neutral evaluator is set out by law, and participation of major creditors is permitted. The goal of the selection process is to establish “buy-in” by the major constituencies, including the municipality, its elected officials, major creditors, taxpayers, and the public at large as to the credibility, objectivity, and professionalism of the neutral evaluator. The municipality is required to pay 50% of the costs of the

⁴⁶ “Letter from Robert G. Nunes, Fiscal Overseer to Secretary Jay Gonzalez of the Office for Administration and Finance; the Massachusetts Senate Committee on Ways and Means and the Massachusetts House Committee on Ways and Means” (July 22, 2010).

⁴⁷ See Chapter 169 of Acts of 2004. The Springfield Financial Control Board ended five years of direct management on June 30, 2009. According to the Commonwealth of Massachusetts, Springfield emerged from a \$41 million deficit in fiscal year 2005 to a reserve fund balance of nearly \$40 million at the close of fiscal year 2009. See http://www.mass.gov/?pageID=mg2utilities&L=1&sid=massgov2&U=sfcb_for_redirect.

⁴⁸ Cal. Gov’t Code §§ 53760; 53760.1; 53760.3; 53760.5; and 53760.7 (as amended and added by Cal. A.B. 506; signed into law on October 9, 2011). This provision was first put to the test by the City of Stockton, California, which filed a Chapter 9 petition in June 2011 after going through a neutral evaluator process. San Bernardino in August 2012 avoided the neutral evaluator process by declaring a fiscal emergency, as discussed below.

neutral evaluator, and creditors will be required to pay the balance unless the parties otherwise agree.

The neutral evaluator is expected to meet with the municipality's representatives and with representatives of each of the major creditors' constituencies and to apply basic mediation techniques including having each side spell out its position, identifying areas of concession or agreement, pointing out to each the weaknesses and strengths of the respective positions, and explaining the consequences of going forward without a resolution, such as costs, risks, uncertainties, and adverse results.

Following the truism that you do not have to touch the stove to know it is hot, or that you can trust what others tell you, the goal of the California law is to avoid the costs, deterioration of services, loss of tax revenues, delay, and uncertainty in the resolution that Chapter 9 or other litigation avenues present. Nevertheless, as a safety valve, the California law provides for a declaration by the municipality that a "fiscal emergency" exists, including a finding by the municipality that the financial status of the local government jeopardizes the health, safety, or well-being of its residents and that the municipality is or will be unable to pay its obligations within the next 60 days, so that a Chapter 9 filing is mandatory at that time and cannot be delayed by the neutral evaluator process.

The use of a neutral evaluator is based upon a recent enactment and is in a developmental stage. Other states are considering the adoption of similar legislation.⁴⁹ Interestingly, the legislation introduced in California was supported by the labor unions as a reaction to the difficulties they experienced in the City of Vallejo Chapter 9 bankruptcy proceeding. Questions have arisen about the effectiveness of the neutral evaluator in actually addressing problems and avoiding a Chapter 9 filing, given Stockton's experience and ultimate filing of Chapter 9 in June 2012 and San Bernardino's avoidance of a neutral evaluator process by claiming a fiscal emergency exception to the requirement.

There will be implementation questions such as:

- How do you ensure participation by all affected creditor representatives?
- How do you motivate the municipality and creditors to drop public posturing, adopt realistic demands, and explore realistic alternatives?
- Who determines what is sustainable and affordable?
- Where do needed additional revenues come from?
- What rights under state laws and constitutional provisions are protected from change, if any, including recognition that statutory liens and special revenues cannot be altered by a municipality or impaired?

⁴⁹ See H.B. 5669 97th Gen. Assemb. (Illinois 2012) (introduced February 16, 2012, by Representative John E. Bradley) and Michigan's Local Financial Stability and Choice Act (2012) as described in footnote 40.

- Are constitutional and statutory laws against impairment of pension benefits a bar to changing labor costs and pension benefits, which in Chapter 9 can be modified?
- What should be allowed to be public about the neutral evaluation process and what should be kept confidential for the sake of honest negotiation, such as whether exceptions from open meetings and freedom of information laws should apply and how confidentiality will be protected?
- What should be done if more than 90 days is required to reach agreement?

Development of the Municipal Protection Commission: A Proposal

The experiences of the New York Financial Control Board, the Rhode Island receiver approach, and the mediator of the California statutory scheme have coalesced in the concept of a municipal protection commission. Under consideration by some states is the use of a municipal protection commission utilizing some of the best aspects from the mediation process of the neutral evaluator and the oversight and supervision of financial control boards and a receiver. Under this municipal debt resolution mechanism, the state would establish an entity that would have a quasi-judicial function and power similar to a commission or special master appointed by a state supreme court or other objective nonpolitical process. The members of the commission would be independent, experienced experts in governmental operation or finance as well as mediation and debt resolution techniques, including bankruptcy. The commission would start with those municipalities that petition for help or those municipalities that have triggered certain established criteria where the jurisdiction of the commission is mandated by state law. The first phase is mediation and consensual agreement by the municipality and the affected creditor constituencies similar to the neutral evaluator process. However, participation by the commission may be required, and negotiation and discussion of positions are strictly confidential. The state law establishing the commission would have an exception to its open meetings law and its freedom of information law to allow for open discussion of these sensitive and confidential topics. If additional tax revenues or loans or grants from the state are needed, recommendations to the state by the commission would take effect unless blocked by the state legislature within a specified period of time. The commission can likewise call for a referendum on a local basis for increased taxes or other actions. Specified time periods for resolution will be set forth, and if the voluntary process is not successful, the second phase is mandatory if the commission so requires.

In the second phase, the commission and its designated members turn into a quasi-judicial panel, and the municipality is required to set forth the steps to be taken to address its specific financial problem (recovery plan). Creditors, workers, and taxpayers will have the ability to comment and to attempt, through negotiation, to modify the recovery plan within a set period of time. Then, the recovery plan is presented to the panel members of the commission for determination of the plan's feasibility and whether it is reasonably fair to creditors' interests in relation to the requirement that, under all circumstances, essential governmental services, at least at an established necessary level, must be maintained for the reasonable future. One of the triggers for the commission's jurisdiction is the petition by the municipality, its workers, or taxpayers that a governmental function emergency exists. The municipality or petition must state that essential services as to the health, safety, and welfare of its residents are being threatened and that the forced reduction in services, given the municipality's financial condition and its revenues, impairs the health, safety, and general welfare of its residents. The commission, after hearing all sides (municipality, workers, taxpayers, affected creditors), will determine:

- What is sustainable and affordable;
- What the municipality can afford;
- What adjustments must be made to the recovery plan to allow the municipality to continue to provide essential governmental services to its residents at established mandated levels to preserve the health, safety, and welfare of its residents and to pay what is feasible to its creditors, including workers' wages and pensions.

The commission will act as an "honest broker" to mandate increases in taxes, where necessary; increases in contributions by the municipality or workers for pension or other benefits, if necessary; or reduction, delay, or stretching out of payments to creditors. Further, if necessary to preserve the public health, safety, and welfare of the municipality's residents, the commission will have the power to reduce workers' wages, pensions, or other benefits.

A municipality that underestimates in its recovery plan its ability to pay creditors and workers will have necessary increases in the payments imposed with the benefits going to the workers and the creditors. A municipality that overestimates its ability to pay or makes promises that are not sustainable and affordable will suffer reduced payments to workers and creditors and possibly increased taxes. The findings of the commission will specify if they are final and enforceable by the parties or if further negotiations or proceedings are necessary. The commission will be charged to make sure that the municipality and the state maintain access to the financial markets, and the ability to borrow will be protected if

possible. This commission process should help protect all parties, workers, vendors, and creditors and the taxpayers and the municipality so they will have needed means of continued financing credibility that can be accomplished on the local level based upon maintaining market credibility. The commission can authorize the municipality to enforce its findings. The findings, determinations, and rulings of the commission can have the force of law by providing that, if the legislature does not act within a short, specified period and overturn the act of the commission, it is the law. This may provide conflicted or fractured legislatures with a graceful resolution with political deniability. Such means of enforcement can include having the recovery plan approved or revised by the commission as the basis for a pre-negotiated or “pre-packaged” Chapter 9 plan. The commission can authorize the municipality to file a Chapter 9 proceeding based on the recovery plan as a pre-packaged Chapter 9 plan. Such a pre-packaged Chapter 9 plan can significantly reduce costs, expenses, uncertainty, and financial market risk of a free-fall Chapter 9 proceeding. In the corporate world, for instance, pre-packaged Chapter 11 plans (corporate plans of reorganization) have been confirmed in weeks rather than months or years with reduced costs, risks, and uncertainties.

This municipal protection commission concept is still in its formative stages and is being discussed in various states. It could be the means of providing state and local government cooperation and oversight while allowing the municipality, its elected officials, workers and unions, creditors and bondholders to have a means of participation with a definitive end result. Further, the resolution for affected workers and creditors can be hard-wired for a payment source of dedicated taxes for assured payment of wages, benefits, and creditor claims rather than the speculative hope of future payment at the willingness of future legislative actions.⁵⁰

The Structure for Oversight and Emergency Financing

Local governments that have encountered financial distress have resorted to financing and oversight authorities (such as New York City and Philadelphia). This approach can involve various degrees of formal oversight and control. In the beginning, it can be as simple and benign as a “commission” that reviews the city budget and makes recommendations based on new revenue sources. If necessary, the commission can develop

⁵⁰ Chapman and Cutler LLP has been working with the Civic Federation of Chicago and its pension committee with regard to the development of the municipal protection authority or commission as an alternative to the rush to Chapter 9 or the continued inability to effectively address financial distress by municipalities. Further, this concept, on a federal level, has been discussed in the presentation on February 14, 2011, to the House Judiciary Subcommittee on Courts regarding state bankruptcies and in the Answers to Follow-On Questions from the Subcommittee directed to James E. Spiotto.

into a refinancing authority with full power to refinance existing debt of the local government and to authorize collection of new revenue sources or withdraw use of new revenue sources if budget recommendations are not followed or met. There are two basic advantages to this approach:

- The new independent issuer can have financial credibility and, therefore, access to borrowing in the capital marketplace if it has an assured source of revenue to pay debt service that is isolated from the bankruptcy and other legal risks; and
- An independent authority can use various tools to enforce fiscal discipline on the local government because it can be removed from political pressures.

The basic idea is that the authority is given a revenue source. It then borrows and assigns the revenue source to pay debt service on the bonds. The authority makes the bond proceeds available to the local government to pay its expenses and retire the deficit. A basic legislative choice is whether the local government levies the new taxes and pledges the proceeds to the authority or the authority is the taxing body authorized to levy taxes. In addition, the sub-sovereign's ability to levy new taxes may be conditioned on a balanced budget or approval of the authority.

Financing through the authority can be used both for a long-term amortization of the cumulative deficit and, if necessary, for an interim period, to accomplish the annual revenue anticipation note borrowings that are necessary for the sub-sovereign to operate. Different revenue sources might be used for each type of borrowing.

The disciplinary tools are important and a wide range of tools can be constructed, including the following:

Grants from the Federal, State, or Regional Governmental Bodies.⁵¹ Obviously, a source of funds has to exist from which to make grants. The grant becomes a tool if the federal, state, or regional governmental body imposes performance conditions as a precondition to any grant. The federal, state, or regional governmental body can make the process more politically palatable by freely making a grant to the authority while requiring either in the legislation or in the grant documents that the authority impose performance requirements.

Loans from the Federal, State, or Regional Governmental Bodies. Instead of a grant, the federal, state, or local governmental body can make loans that require ultimate repayment. The repayment terms can be varied depending upon the local government's compliance with an approved

⁵¹ "Regional Governmental Bodies" could include counties, municipalities, or regional governmental bodies for special purposes such as transportation, public safety, or health services.

financial plan and the achievement of goals over time. That is, interest rates can be increased or decreased as needed; in a worst-case scenario, principal payment can be accelerated for a default. There can also be in certain states the assumption of the obligations by the state.

Intercepts. Part of the discussion in structuring grants and loans should consider “intercepting” the payments to the local government. Legislation can be written that permits the state or regional governmental body to withhold these payments if the local government acts inappropriately or fails to act, or that permits those revenues to be pledged (e.g., paid directly) to lenders or bondholders. In the implementation stage, there is an issue of whether special interest groups, such as unions, local financial institutions, or pension funds might have the ability and willingness to invest in such financing. New York City had support from unions in purchasing significant positions of its refinancing debt.

Budget Process Involvement. Having a financial plan to work out of the deficit, following that plan, and changing the plan as experience dictates are the keys to a successful workout. The first step is to identify the problems and to stop the financial bleeding to the degree possible.

Required Financial Performance. The authority can legislatively be given powers to participate in and monitor the local government’s budget process across a broad spectrum. Ultimately, the teeth in the program are that bond proceeds or new tax revenue sources are not made available to the local government until it complies with the plan, and that continued compliance is required for a continuing revenue flow. The legislation itself can contain the requirements, or it can authorize the authority to develop and establish the requirements.

Legislative Assistance. A financially distressed local government comes as a somewhat recalcitrant beggar to the legislature. An authority that is monitoring (and actively participating in) the local government’s recovery can give it credibility with the legislature or, alternatively, if the local government fails to make progress, can assist the legislature in developing new criteria and programs.

Moral Obligations of the State. Some states may be constitutionally able to assume debt of a local government. In such states, an “extra-legal” state guaranty called a “moral obligation” is sometimes used to credit enhance bonds.

Appointment of Authority Members. The makeup of the governing body of the authority is critical to its success. Payment of its staff is important. It is conceivable that some community leaders may be willing to serve without compensation if they believe the authority and its tools are capable of success. Whether or not the local government is able to appoint or be represented on the authority is a question for the drafters of the legislation.

Acceleration of Loans. If the authority makes loans to the local government, the loan could include the right to accelerate repayment of the obligations if the local government fails to comply with the recovery plan.

Publicity. By participating in the local government recovery process, the authority can become a mechanism for disseminating both good and bad information about the progress of the local government's recovery efforts. Such information flow and disclosure will be helpful in building credibility with the investment community. The experiences of New York City, Cleveland, and Philadelphia stress the importance of accurate and clear communication with the financial market.

Powers. The authority can have as many or as few powers as the legislature may require, including but not limited to:

1. Authorizing filing of a judicial action for municipal debt adjustment by the local government;
2. Granting, after hearing and notice, a stay against litigation and debt enforcement;
3. Approving or withdrawing future use of increased tax revenues;
4. Rejecting or approving budget, financial plans, and future financing;
5. Determining financial emergency or recovery;
6. Approving, expediting, or withholding state aid and entitlement to taxes distributed to the local government;
7. Approving or issuing bonds for refinancing or paying local government deficit or extraordinary operating expenses;
8. Reporting to the state regarding the need for further legislative or disciplinary tools; and
9. Transferring certain governmental services to other governmental bodies or consolidating governmental services on a regional basis or with other municipalities.

Consolidation of Regional Essential Governmental Services. One interesting proposition for states is whether certain essential governmental services such as public safety (police and fire) or public health or education should be consolidated and combined on a regional basis to gain the benefits of the efficiencies and elimination of duplicative and overlapping services and administration.

Legislation can be written so that some or all of the above-described tools are available to the authority. These tools can be designed and enacted so that they are mandatory or discretionary. The choices and variations can be further delineated. A variation of the intercept and periodic financial reporting has been used in connection with troubled debt securities issued by local government as a mechanism to ensure the flow of payments from taxes or fees to the bondholders.

Any state municipal refinancing or restructuring board should have sufficient power and authority under state law to effectively supervise a distressed local government. Accordingly, any such municipal oversight and reference authority should be authorized to be able to:

1. Require balanced budgets and provide economic discipline and reporting;
2. Issue debt in the state's name or as a separate entity to obtain market credibility and access;
3. Have the power to negotiate debt restructuring and quasi-judicial jurisdiction;
4. Review services or costs that can be transferred to other governmental bodies;
5. Have the right to intercept tax revenue and ensure payment for essential services and necessary operating costs;
6. Have the power to authorize a Chapter 9 filing if needed;
7. Obtain bridge financing of, or refinance, troubled debt;
8. Transfer certain services to other governmental agencies to reduce expenditures;
9. Grant funds to the municipality to bridge the financial crisis;
10. Provide funds to the municipality by means of a loan with terms that are realistic or payable from out-of-state tax sources that can be offset;
11. Use an intercept of state tax payable to the municipality to ensure essential municipal service;
12. Create private-public partnerships to lease and sell municipal properties to provide bridge financing and cash-flow relief;
13. Develop a vendor assistance program to provide vendor payments through financing by purchase of vendor claims at a discount (fixed discount) and secured by payment from dedicated tax revenues over time or provide current cash flow relief from current or future vendor payments;
14. Explore the consolidation on a regional basis of certain governmental services; and
15. Monitor compliance with any restructuring plan to ensure compliance and prevent financial erosion.

Conclusion

The states have divergent techniques for addressing the financial woes of their municipalities. As always, because each state has unique laws for

addressing municipal issues, for any specific questions, details, or issues, further analysis and consultation with professional advisors may be advisable. In addition, should a state's guidance, oversight, and assistance to a troubled municipality fail, the last resort is to the use of Chapter 9 of the U.S. Bankruptcy Code (Municipal Debt Adjustment).⁵²

WHY CHAPTER 9 MUNICIPAL DEBT ADJUSTMENT IS THE LAST AND LEAST PREFERRED RESORT

It is obvious that the resort to use of municipal bankruptcy by a local government is an admission that the local government and the state have failed to address the situation effectively. That is why few local governments of any size have even entertained, let alone used, a Chapter 9 proceeding. Historically, Chapter 9 has been used primarily by small tax districts and municipalities, and major issuers of municipal debt have refrained from proceeding with a Chapter 9 filing. Since 1937, when Chapter 9 was instituted and as of May 24, 2013, there have been 646 Chapter 9 filings.

There have been 302 filings of Chapter 9 since 1954 (as of May 24, 2013). Of those filings, only seven have been municipal debt issuers of any significance, namely:

1. Orange County, California, in 1994, in which the public debt was refinanced and paid (population approximately three million and debt of more than \$1.974 billion);
2. The City of Bridgeport, Connecticut, in 1991, which case ultimately was dismissed (population of approximately 140,000 and debt of more than \$220 million);
3. The City of Vallejo in 2008, which exited bankruptcy in August 2011 (population of approximately 115,942 and debt of more than \$175 million);
4. Harrisburg, Pennsylvania, in September 2011, which case was promptly dismissed for not being authorized under state law (population of approximately 49,673 and debt of more than \$400 million);
5. Jefferson County, Alabama, which filed its petition in November 2011 (population of approximately 658,931 and debt of more than \$4.2 billion);
6. Stockton, California, June 2012 (population of approximately 291,707 and debt of more than \$1 billion); and

⁵² See "Analysis of Investors Rights and Remedies" as set forth in *Municipalities in Distress?* chap. 5.

7. San Bernardino, California, in August 2012 (population of approximately 213,012 and debt of more than \$492 million).⁵³

Approximately one-fourth of the 302 Chapter 9 filings since 1954 have been dismissed, rather than being completed by confirming a plan of debt adjustment. Similarly, since 1937 about a quarter of all Chapter 9s filed have been dismissed and have not resulted in a plan of debt adjustment being confirmed. This suggests that, even after filing, other alternatives may be more attractive resolution mechanisms. Even more interesting is that, of the 62 cities, towns, villages, and counties that filed Chapter 9 between 1954 and December 31, 2012, 29 (46%) were dismissed without a plan of adjustment having been filed. This supports the proposition that, for traditional municipalities, which must continue to provide essential government services, Chapter 9 truly is a last resort, even less desirable after filing than other alternatives of resolution or refinancing. Although municipal enterprises such as special districts and utilities may reach a structural dead end and see a Chapter 9 filing as a logical final step, cities, towns, villages, or counties will do anything to avoid the stigma and adverse effect of Chapter 9 and a Chapter 9 plan of debt adjustment.

Although corporate issuers recently have filed more than 11,000 Chapter 11 cases per year, the Chapter 9 filings, even during the current economic downturn, have been few: five in 2007, four in 2008, 10 in 2009, six in 2010, 13 in 2011, and 12 in 2012. It is no accident that New York City in 1975, Cleveland in 1978, and Philadelphia in 1991, when faced with a financial crisis, chose other viable alternatives rather than filing Chapter 9. Chapter 9 provides no additional revenues or tax sources to solve the problem, and it upends all creditor relationships—not just the few that are the problem. Further, the stigma and travail of Chapter 9 are more than many local governments can tolerate.

Chapter 9 is a vehicle, not for elimination of debt, but rather for debt adjustment. Specifically, a Chapter 9 proceeding is a mechanism for a debtor municipality, through a court-supervised proceeding, to attempt to settle disputes with its creditors. Because a municipal unit cannot liquidate its assets to satisfy creditors and continue to function as a municipality, the primary purpose of Chapter 9 is to allow the municipal unit to continue

⁵³ It is interesting to note that between 1937 and 1972, there were 362 Chapter 9 filings of which 79 were dismissed and 10 were still pending in 1972. The remaining 273 Chapter 9 filings that actually had a plan of debt adjustment filed and confirmed by 1972 involved only \$217,230,541 of admitted debts in aggregate with losses of only \$76,615,745 in aggregate, or a recovery of about 65%. See “City Financial Emergencies: The Intergovernmental Dimension, Advisory Commission on Intergovernmental Corporations,” July 1973. This can be compared to the corporate commercial bond and loan recovery rate between 1982 and 2009 ranging from 22.1% to 55.57% recoveries. See “Moody’s Corporate Default and Recovery Rates 1920–2008” (2009).

operating while it adjusts or refinances creditor claims. Indeed, one of the stated purposes of the Bankruptcy Code was to provide a “workable procedure so that a municipality of any size that has encountered financial difficulties may work with its creditors to adjust its debts.”⁵⁴

The historical reluctance by municipalities to embrace Chapter 9 is reflected in the number of states that have chosen to authorize their municipalities to use Chapter 9 municipal bankruptcy. In order for a municipality of any state to file Chapter 9 municipal bankruptcy, the municipality must be specifically authorized to file a Chapter 9 proceeding by the state. The states have adopted different approaches to this requirement and, in most cases, states indicate their preference that Chapter 9 municipal bankruptcy be the last resort or no resort at all. Twelve states have statutory provisions specifically authorizing the filing by an in-state municipality of a Chapter 9 petition.⁵⁵ Another 12 states authorize a filing conditioned on a further act of the state, an elected official, a state entity, or some other party.⁵⁶ Three states grant limited authorization,⁵⁷ and two states prohibit filing, but one of them has an exception to the prohibition.⁵⁸ The remaining 21 states either are unclear or do not have specific authorization with respect to filing. The District of Columbia and Puerto Rico are not permitted to file.⁵⁹

The difficulties that the City of Cleveland faced in 1978 when it was suffering financial challenges and experienced no practical access to the capital markets were a motivating factor for Congress in the 1980s to examine Chapter 9 and pass the 1988 Amendments to the Bankruptcy Code. These amendments provided the assurance to municipalities that, in the issuance

⁵⁴ H.R. Rep. No. 137, 93rd Cong., 1st Sess. 237248.

⁵⁵ See *Municipalities in Distress?* Section 7: 50 State Survey charts for Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas, and Washington. The constitutionality of Alabama’s code with respect to that state’s municipalities filing Chapter 9 petitions is currently being considered by the Alabama Supreme Court as to whether it is limited to municipalities that have issued bonds as opposed to other debt obligations. On March 4, 2012, the United States Bankruptcy Court in the Jefferson County Chapter 9 proceeding decided that warrants were historically included as bonds in § 11-81-3 of the Alabama Code and, therefore, the state has authorized counties to adjust their indebtedness under Chapter 9 of the Bankruptcy Code.

⁵⁶ See *Municipalities in Distress?* Section 7: 50 State Survey charts for California, Connecticut, Florida, Kentucky, Louisiana, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Rhode Island. California adopted in 2011 the requirement that a municipality must first use in good faith a neutral evaluator before being authorized to file Chapter 9 except for certain financial emergency situations.

⁵⁷ See *Municipalities in Distress?* Section 7: 50 State Survey charts for Colorado, Illinois, and Oregon.

⁵⁸ See *Municipalities in Distress?* Section 7: 50 State Survey charts for Georgia and Iowa (except for debt involuntarily incurred).

⁵⁹ The term “State” is defined in the Bankruptcy Code as including “the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor” under Chapter 9. 11 U.S.C. § 101(52).

of special revenue bonds, they would have access in good times and in bad to the capital markets and the ability to borrow funds to avoid financial meltdown and to help fund the recovery process. Among the mechanisms state and local governments use to assure payment to municipal bond investors is the use of special revenue bond financing and bonds supported by statutory liens. The case law in Chapter 9 supported by the legislative history of the 1988 Amendments recognizes that special revenues and statutory liens should not be impaired in a Chapter 9 proceeding. There will continue to be a growing use of special revenue bonds and statutory liens to ensure that municipalities, especially those that are financially challenged, can commit to those who provide credit that they will receive special treatment in the repayment of that debt.⁶⁰

As we know, there has been a continuing debate as to the proper role of a parent when a child reaches maturity. Should it be a hands-off approach in which it is up to the mature child to fend for him or herself? Should the parent be there to provide assistance when needed to help out in difficult situations? Should there be an intense supervision by a “helicopter” parent, who will monitor every action and relive every event in the child’s mature life? In the past, we have found examples of each of these approaches to a state’s supervision of its local governments in times of financial distress. Although we may all debate what type of parenting is best for local government, there has been and continues to be, a cry for more active oversight and assistance by states. Given the recent legislation passed by some of the states, including Indiana, Michigan, and Rhode Island, and the long-standing legislation in New York, Pennsylvania, and elsewhere, it can be concluded as many contend that the state’s oversight, assistance, and support in times of financial challenge are a necessity. The financial success of the state can be no greater than the financial success of its municipalities and, in particular, its largest ones. For that reason, the financial troubled waters of local governments must be bridged and essential governmental services must be maintained and assured. Further, costs and expenses that are objectively unsustainable and unaffordable must be identified at an early date and addressed so that financial meltdown is not the only option.

A minority of states permit their municipalities to file Chapter 9 and, even if they do, they may still require further oversight or approval by some elected state official authority or agency to ensure that the use of

⁶⁰ See *In re County of Orange*, 189 BR 499 (C.D. Cal. 1995) (statutory liens); *In re Jefferson County, Alabama*, 474 BR 725 (Bankr. N.D. Ala. 2012) (special revenues); *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. La. Sept. 13, 2012) (special revenues and statutory lien); Act to Amend the Bankruptcy Law to Provide for Special Revenue Bonds and For Other Purposes, Pub. L. No. 100-597 (1988).

Chapter 9 is consistent with state policies and that all other alternatives have been explored. This position of the states has been reinforced by the less than great results delivered by Chapter 9. For the most part, Chapter 9 municipal bankruptcies have been more expensive, complicated, and time consuming than expected and have produced results that were less desirable or predictable than expected. Further, Chapter 9 municipal bankruptcy is a process, not a solution. After filing, the municipality has no more cash liquidity, tax revenues, or anticipated revenue than it had outside a Chapter 9 proceeding. It is still the burden of the municipality to develop a realistic recovery plan that is sustainable and affordable.

For these reasons, the role of the state in assisting its local governments has been, and will continue to be, to encourage alternatives to a bankruptcy filing under Chapter 9. States have played and will continue to play a vital role in the financial well-being of their local governments. There is a growing trend for more active supervision and hands-on management, as demonstrated by the recent legislation in Rhode Island (receiver) and in Michigan and Indiana (emergency manager). In this way, the state can ensure to its citizens that the local governments will provide essential governmental services at a level acceptable to the state and citizens even in times of financial challenge. The state, through such mechanisms, will ensure that its local governments and citizens are not alone in addressing the problem, ensuring the desired maintenance of essential governmental services at an acceptable level. Further, through the use of state statutory liens or special revenue financing, needed funds and the source of repayment in times of distress can be provided and deemed to be less expensive than a Chapter 9 proceeding. The developing concept of a municipal protection commission improves upon past mechanisms by allowing the state to provide the oversight in the determination of what is sustainable and affordable for its local governments. Although there are many examples of mechanisms by states that have worked well in the past, we can use the present experiences to construct more effective and efficient models that will meet the challenges we will face in future economic downturns. The time for considering, developing, and implementing those best practices is now. Then, when financial distress again raises its troublesome head, the state, its municipalities, and the municipalities' workers, vendors, and investors will have a clear path to follow.



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